

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 05-0213
Corporate Income Tax
For the Years 1998-2004**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Corporate Income Tax—Assessment

Authority: IC 6-8.1-5-1(b); IC 4-30; IC 4-31; IC 4-32; IC 4-33; IC 4-30-1-1; IC 4-30-18-1; IC 4-31-1-2; IC 4-31-6; IC 4-31-9; IC 4-32-1-2; IC 4-32-4-1; IC 4-32-4-2; IC 4-32-9; IC 4-32-9-16; IC 4-32-9-18; IC 4-32-9-30, -31, -32, -33; IC 4-33-1-1; IC 4-33-1-2; IC 4-33-6; IC 4-33-6-1; 4-33-6-3.5; IC 4-33-7; IC 4-33-8; IC 4-33-8-2; IC 4-33-8-4; IC 4-33-8-6; IC 4-33-8-3; IC 4-33-8-2; IC 4-33-8-4(2); IC 4-33-9-8; IC 4-33-9-12; 4-33-13-1; IC 4-33-13-1.5; IC 6-3-2-1(b); 68 IAC 2-6-29(1); IRC § 501(c)(19); IRS Publication 3386; IRS Publication 598; IRS Publication 3079

Taxpayer protests the method by which the audit arrived at the amount of taxpayer's tax liability.

STATEMENT OF FACTS

Taxpayer is a tax exempt veterans organization under IRC § 501(c)(19). Taxpayer was assessed unrelated business income on receipts from nineteen unsanctioned slot machines operated by Taxpayer. The income was computed by deducting payouts and a portion of the business expenses from the gambling receipts. The building expenses were calculated based on the square footage of floor space covered by the slot machines.

Taxpayer protests the method the audit used to calculate the amount of taxpayer's liability, arguing that expense deductions for telephones, repairs, payroll processing, office supplies, dues, advertising, and kitchen wages should have been allowed to offset the income earned from gambling.

DISCUSSION

Under Indiana code, passed into law by the Indiana General Assembly, all tax assessments are presumed to be valid and accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC § 6-8.1-5-1(b). The Indiana General Assembly has passed into law what is

permissible and impermissible gambling in the State of Indiana. IC § 4-30 establishes an Indiana state lottery. IC § 4-31 establishes pari-mutuel wagering on horse races. IC § 4-32 establishes games of chance. And IC § 4-33 establishes riverboat gambling. Gambling in Indiana is regulated; organizations are required to be registered and licensed.

The Indiana General Assembly has stated that the purpose of establishing state lottery games is to "enable the people of Indiana to benefit from significant additional money for capital improvements." IC 4-30-1-1. No person or organization may operate a lottery in Indiana; only the state lottery commission may operate a lottery. IC § 4-30-18-1.

The Indiana General Assembly has stated that the purpose of permitting pari-mutuel wagering on horse races in Indiana is "to ensure that [it] will be conducted with the highest of standards and the greatest level of integrity." IC § 4-31-1-2. Racetrack personnel and racing participants are required to be licensed. *See*, IC § 4-31-6. Taxation and distribution of pari-mutuel revenues is highly regulated. *See*, IC § 4-31-9.

The Indiana General Assembly has stated that the purpose of permitting games of chance is "to permit a licensed qualified organization (1) to conduct bingo events, charity game nights, door prize drawings, and raffles; and (2) to sell pull tabs, punchboards, and tip boards; as a fund raising activity for lawful purposes of the organization." IC § 4-32-1-2. Organizers are required to withhold state income tax on prizes awarded to a winner and to submit that tax. *See*, IC § 4-32-4-1 and IC § 4-32-4-2. Organizations are required to be licensed and are regulated in the conduct of the games. *See*, IC § 4-32-9. Under IC § 4-32-9-16, the Department is permitted by rule to set the allowable expenditures of a qualified organization. The Department has the authority, granted by the Indiana General Assembly, to set the guidelines for allowable expenditures. This directly implies that the Department also may set the guidelines for permissible deductions of expenses. All net proceeds from an allowable event and related activities may only be used for the lawful purposes of the qualified organization. *Id.* There are limits on the number and frequency of events that may be held. IC § 4-32-9-18. There are limits on the value of prizes. IC §§ 4-32-9-30, -31, -32, -33. There are many more statutes regulating charity gaming; these are named to demonstrate that strict regulations and statutes exist.

Additionally, there is the issue and existence of casino gambling. The people of Indiana, acting through the General Assembly, restrict casino gambling solely to licensed riverboats. Casino gambling is restricted to counties that border Lake Michigan, the Ohio River, or a historic hotel district. *See*, IC § 4-33-1-1. The General Assembly highly restricts where casino gambling may be conducted. The Indiana General Assembly has stated that the purpose of permitting riverboat casino gambling is "to benefit the people of Indiana by promoting tourism and assisting economic development. The public's confidence and trust will be maintained only through: (1) comprehensive law enforcement supervision; and (2) the strict regulation of facilities, persons, associations, and gambling operations under this article." IC § 4-33-1-2. Owners are to be licensed. *See*, IC § 4-33-6. There are restrictions on who may be an owner, *id.*, and how many licenses may be issued, IC § 4-33-6-1 and IC § 4-33-6-3.5. Suppliers are to be licensed. *See*, IC § 4-33-7. The occupational employees of a riverboat are to be licensed. *See*, IC § 4-33-8. The backgrounds of the employees are investigated and they are fingerprinted. *See*, IC § 4-33-8-2, IC § 4-33-8-4, and IC § 4-33-8-6. Felons are not permitted to hold an occupational license. IC § 4-

33-8-3. An occupational license is must be renewed annually. IC § 4-33-8-2. The person only may be employed by one riverboat. IC § 4-33-8-4(2). All of the above-mentioned statutes have been named, so as to outline the strict regulatory guidelines established by the people of the State of Indiana acting through their duly elected voices in the General Assembly.

Under IC § 4-33-9-8, casino gambling equipment and supplies may be purchased or leased only from licensed suppliers. IC § 4-33-9-12 does not permit those under the age of twenty-one to be in any area in which casino gambling is occurring. IC § 4-33-13-1 and IC § 4-33-13-1.5 outline the tax schedules for revenues earned from casino gambling. This tax rate is as low as 15% and as high as 35%. Currently, the corporate income tax rate is 8.5%. *See*, IC § 6-3-2-1(b). The 8.5% corporate income rate is less than the 15% minimum tax assessed against casino gambling on riverboats. Were Taxpayer legally sanctioned to operate a casino, it would have to pay almost double the tax rate that the Department assessed for Taxpayer's unsanctioned operation of slot machines. Were Taxpayer legally operating these slot machines, it would be held to the gaming regulations as to the payout requirements. *See*, 68 IAC 2-6-29(1). According to the Indiana Gaming Commission, riverboat casinos' payouts average around 93%. Taxpayer pays out at around 80%. Taxpayer states that the bartender at the post pays out any winnings.

Tax assessments on activities are not based upon the morality or legality of the activities. The Department does not base an assessment upon whether the income earned by a taxpayer is earned legally; the Department simply applies the tax statutes and regulations. At issue in this case is income earned by Taxpayer from unrelated business activities. This requires a discussion as to the functions and purposes of an IRC § 501(c)(19) veterans' organization.

The IRS has issued three publications useful to this discussion:

- Publication 3386 Tax Guide—Veterans' Organizations (6/99)
- Publication 598 Tax on Unrelated Business Income of Exempt Organizations (3/00)
- Publication 3079 Gaming Publication for Tax-Exempt Organizations (4/98).

Publication 3386 provides that: “[v]eterans' organizations occupy a special place in the world of exempt organizations.” *Id.* at 3. Over the years, Congress has provided more flexible exemption provisions to veterans' organizations to help keep them vibrant contributors to veterans and their communities at large. *See id.* Originally, veterans' organizations were required to have a membership of at least 75% war veterans in order to be tax-exempt; but because of waning membership over the years, Congress changed the membership requirement to 75% veterans. *See id.*, and IRC § 501(c)(19)(B). However, Congress still requires that no more than 2.5% of the members be non-veteran related persons in order for the organization to maintain tax-exempt status. *See id.*

Congress has stated that appropriate purposes of an IRC 501(c)(19) veterans' organization include:

- A. promoting the social welfare of the community,

- B. assisting needy and disabled veterans, widows, or orphans of deceased veterans,
- C. providing entertainment, care and assistance to hospitalized veterans or members of the Armed Forces of the United States,
- D. perpetuating the memory of veterans and comforting their survivors,
- E. conducting programs for religious, charitable, scientific, literary, or educational purposes,
- F. sponsoring or participating in patriotic activities,
- G. providing insurance benefits to members or members' dependents, and
- H. providing social and recreational activities for members.

See IRS Pub. 3386 at 9. IRS Publication 3386 states that a veteran's organization can jeopardize its tax-exempt status if it does not limit its activities and operations to post members—but instead opens its facilities to the general public. A post may operate a bar & restaurant and also may provide gambling, but these must be restricted to members and their invited guests. All expenses of an invited guest are to be paid by the post member.

Taxpayer engages in many activities and opens its post to the general public for many reasons. Taxpayer has a kitchen area, restaurant area, bar area, indoor pool, banquet/meeting rooms, and several other rooms. Taxpayer receives income from dues, sales of food and beverages, miscellaneous sales of merchandise to members, renting out rooms for banquets, wedding receptions, meetings, etc. Income is also received from having bingo three times a week and selling pull-tabs during bingo and at the bar area. Taxpayer also has twenty-six Cherry masters slot machines. In the Department's audit of Taxpayer, only the income from the unsanctioned slot machines was assessed tax as being unrelated business income. The Department has sought only to tax the unsanctioned gambling as unrelated business income. The Department has computed the reasonable deductions related to the generation of that income.

Expenses, but not losses, directly related to the earning of unrelated business income can be used as a deduction in calculating the income. There is no evidence to establish that any of the food and beverage related expenses, or other expenses taxpayer wishes to take as deductions, are directly related to gambling receipts. Taxpayer's organizational purpose would have to be gambling in order for Taxpayer's position to be valid. The Department has allowed a reasonable estimate of building expenses to offset the unrelated business income. No evidence has been submitted to support further deductions for expenses.

FINDING

Taxpayer's protest concerning the method the audit used to arrive at its tax liability is denied.